NOTE 23 – CONTINGENCIES AND COMMITMENTS

A. Primary Government

Litigation

In the government-wide and proprietary fund financial statements, the State accrues liabilities related to significant legal proceedings if a loss is probable and reasonably estimable. In the governmental fund financial statements, liabilities are accrued when cases are settled and the amount is due and payable.

The State is a party to various legal proceedings seeking damages, injunctive, or other relief. In addition to routine litigation, certain of these proceedings could, if unfavorably resolved from the point of view of the State, substantially affect State programs or finances. These lawsuits involve programs generally in the areas of corrections; tax collection; commerce and budgetary reductions to school districts and governmental units; and court funding. Relief sought generally includes damages in tort cases; improvement of prison medical and mental health care and refund claims for State taxes. The State is also a party to various legal proceedings that, if resolved in the State's favor, would result in contingency gains to the State, but without material effect upon fund balance/net assets. The ultimate dispositions and consequences of all of these proceedings are not presently determinable, but such ultimate dispositions and consequences of any single proceeding or all legal proceedings collectively should not themselves, except as listed below, in the opinion of the Attorney General of the State and the Office of the State Budget, have a material adverse effect on the State's financial position. Those lawsuits pending which may have a significant impact or substantial effect on State programs or finances, if resolved in a manner unfavorable to the State, include the following:

Durant et al v State of Michigan: On November 15, 2000, more than 365 Michigan school districts and individuals filed two suits in the Michigan Court of Appeals. The first suit, Durant et al v State et al ("Durant III"), asserts that the State School Aid appropriation act, P.A. 297 of 2000, violates the Michigan Constitution, Article 9, §§ 25-34 (the "Headlee Amendment"), because it allegedly transfers per pupil revenue guaranteed to school districts under the Constitution of 1963, Article 9, § 11, for unrestricted school operating purposes, in order to satisfy the State's independent funding obligation to those school districts under Article 9, § 29. The State won this case in the Court of Appeals, and the Supreme Court denied the plaintiffs' application for leave to appeal.

The second suit, Adair et al v State et al ("Adair"), asserts that the State has, by operation of law, increased the level of various specified activities and services beyond that which was required by State law as of December 23, 1978 and, subsequent to December 23, 1978, added various specified new activities or services by State law, including mandatory increases in student instruction time, without providing funding for these new activities and services, all in violation of the Headlee Amendment. In the original complaint, the Adair plaintiffs sought an unspecified money judgment equal to the reduction in the State financed proportion of necessary costs incurred by the plaintiff school districts for each school year from 1997-1998 through the date of any judgment and for attorneys' fees and litigation costs. The Adair plaintiffs also sought a declaratory judgment that the State has failed to meet its funding responsibility under the Headlee Amendment to provide the plaintiff school districts with revenues sufficient to pay for the necessary increased costs for activities and services first required by State law after December 23, 1978, and to pay for increases in the level of required activities and services beyond that which was required by State law as of December 23, 1978.

On January 2, 2001, plaintiffs filed a first amended complaint in both Durant III and Adair increasing the number of school district plaintiffs to 443. On February 22, 2001, plaintiffs filed a second amended complaint in Durant III increasing the number of school district plaintiffs to 457. On April 16, 2001, plaintiffs filed a second amended complaint in Adair increasing the number of school district plaintiffs to 463. The second amended complaint includes a request for declaratory relief, attorneys' fees and litigation costs but does not include a request for money judgment.

On April 23, 2002, the Court of Appeals dismissed the complaint in Adair in its entirety and with prejudice. Plaintiffs filed an application for leave to appeal and a motion for immediate consideration of the application for leave to appeal in the Michigan Supreme Court on May 14, 2002, which was granted on December 18, 2002.

On June 9, 2004, the Michigan Supreme Court issued its opinion in Adair. The Court held that, with three exceptions, all of the plaintiffs' claims were barred by the doctrines of *res judicata* and release. The Court ruled that all but three of the claims that plaintiffs alleged were new or increased activities could have been included in the Durant I litigation because the activities existed during the time that the Durant I litigation was pending.

The other three claims involve statutes that were enacted after the Court's 1997 Durant I decision. The Court ruled that two of these post-Durant I statutes are not new mandates because the activities are either not new or are merely permissive. The third claim involves the record keeping activities and the operation of the Center for Educational Performance and Information, which was created by Executive Order in 2000 (MCL 380.1752; EO 2000-9). Plaintiffs alleged that the statute and Executive Order require districts to create and maintain student data following State-specified data-gathering procedures and transmit the data electronically to the State. The Supreme Court ruled that the plaintiffs' allegation that districts had to now actively participate in maintaining data that the State requires for its own purposes presents a colorable claim under the Headlee Amendment. The Court reversed the Court of Appeals' dismissal of the claim and remanded the issue to the Court of Appeals to determine whether this claim constitutes a new State-mandated activity in violation of the Headlee Amendment. A Motion to Dismiss is pending before the Court of Appeals. If the plaintiffs prevail in the record keeping claim, there could be financial liability for the State.

County Road Association of Michigan et al v John M. Engler et al: On March 6, 2002, the County Road Association of Michigan and the Chippewa County Road Commission filed a complaint in Ingham County Circuit Court challenging various provisions of Executive Order 2001-9. The Executive Order was proposed by the Governor and approved by the appropriations committees of both houses of the Legislature on November 6, 2001, for the purpose of reducing appropriated expenditures, to balance the State budget. The complaint consists of five counts, alleging that Defendant State agencies: (1) violated Article 9, Section 9 of the State Constitution, by unlawfully allowing the Department of State to bill the Department of Transportation for expenses in excess of those necessary to collect motor vehicle taxes and fees; (2) violated Article 9,

Section 9 of the State Constitution, by utilizing, for non-transportation purposes, revenues from the sale of information, or products, the creation of which was funded by constitutionally restricted transportation funds; (3) violated Article 5, Section 20 and Article 9, Section 17 of the State Constitution, and MCL 247.661 *et seq* by allowing the Department of Treasury to bill the Department of Transportation for expenses in excess of those necessary to collect motor vehicle taxes and fees; (4) violated Article 9, Section 17 of the State Constitution, by transferring funds from the Comprehensive Transportation Fund (CTF) to the General Fund; and (5) violated Article 9, Section 17 of the State Constitution, by transferring funds from the Transportation Economic Development Fund to the General Fund.

Three public transit authorities have intervened in the suit, asserting a single claim identical to that alleged by Plaintiffs with respect to the CTF. The Plaintiffs and Intervenors seek preliminary and permanent injunctive relief to nullify particular provisions of Executive Order 2001-9 and to restore funding to the CTF, the Michigan Transportation Fund (MTF), and the Transportation Economic Development Fund.

The Plaintiffs and Intervenors obtained two injunctions from Ingham County Circuit Court Judge William E. Collette. One injunction barred the State from diverting $20 million to the General Fund from the MTF and the other barred the State from diverting $12.8 million to the General Fund from the CTF. The State was granted interlocutory appeals on February 19, 2003, and the Court of Appeals stayed the two injunctions. On January 13, 2004, in a published opinion, the Court of Appeals vacated the CTF injunction, and remanded for dismissal, holding that Executive Order 2001-9 legitimately diverted $12.8 million from the CTF to the General Fund. On the same day, in an unpublished opinion, the Court of Appeals reversed in part and affirmed in part the MTF injunction, holding that $12.5 million was legitimately diverted from the MTF to the General Fund but that the remainder was not. In February 2004 Intervenors filed an application in the Supreme Court seeking reversal of the Court of Appeals as to the CTF injunction.

In April 2004 the State filed an application for leave in the Supreme Court seeking reversal of the Court of Appeals as to the unfavorable portion of the decision affecting the MTF injunction. That same month Plaintiffs filed an application in the Supreme Court seeking reversal of the Court of Appeals as to the favorable portion of the decision affecting the MTF injunction. In September 2004 the Supreme Court entered an order holding the two applications concerning the MTF injunction in abeyance and notifying the parties that it is considering the application concerning the CTF injunction and the oral argument will be heard and supplemental briefs may be filed. The State may have to provide an alternate source of funding to balance the budget and make up revenue shortfalls of approximately $35 million of the original $60 million sought.

Two consolidated class actions, representing approximately 4,000 motor carriers subject to Michigan regulation, originated in the Court of Claims in Westlake, et al v State of Michigan and Troy Cab v State of Michigan, et al. The motor carriers claim a full refund of annual motor carrier authority fees and per vehicle fees (plus interest) dating back to 1982. The amount of such fees collected approximates several million dollars per year.

On March 11, 2003, the Michigan Court of Appeals dismissed all claims against the State. Plaintiffs' Applications for Leave to Appeal at the Michigan Supreme Court were denied on December 3, 2003. However, the Plaintiffs have now filed Petitions for Writs of Certiorari at the U.S. Supreme Court, which has requested briefs from the Department of Justice on the merits of the Petition. Based on the position taken in the Department of Justice briefs, it is reasonably possible that Plaintiffs will prevail. The entire potential claim, including interest, could exceed $75 million.

Comben v State of Michigan: The Court of Appeals held that in light of Section 15 of the Severance Tax Act, MCL 205.315, severed oil and gas are not subject to taxation and foreclosure under the General Property Tax Act. Plaintiff Antrim County Treasurer originally sought a declaratory ruling whether owners of severed oil and gas interests were entitled to notice of tax foreclosures under the new tax foreclosure process adopted in 1999 P.A. 123. The trial court and the Court of Appeals held that under the severance tax act and the dormant minerals act, severed oil and gas rights are not subject to taxation and foreclosure. An Application for Leave to Appeal has been filed with the Michigan Supreme Court.

The State presently holds mineral rights only in 2.1 million acres of land, and mineral and surface rights in another 3.8 million acres of land, which reverted to the State for tax delinquencies and which are administered by the Department of Natural Resources. The vast majority of these 5.9 million acres of mineral rights were obtained by tax foreclosures occurring before 1941. State revenues from oil and gas activities over the last 10 years have averaged approximately $35 million annually. A separate class action to quiet title to severed oil and gas rights and for damages is presently pending in Antrim County Circuit Court. The action is consolidated with a Court of Claims action with the same name (Black Stone Minerals v State of Michigan).

Federal Grants

The State receives significant financial assistance from the federal government in the form of grants and entitlements. The receipt of federal grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal regulations. Substantially all federal grants are subject to either federal single audits or financial and compliance audits by grantor agencies. Questioned costs as a result of these audits may become disallowances after the appropriate review of federal agencies. Material disallowances are recognized as fund liabilities in the government-wide and proprietary fund financial statements when the loss becomes probable and reasonably estimable. As of September 30, 2004, the State estimates that additional disallowances of recognized revenue will not be material to the general purpose financial statements.

Federal sanctions that may result in a loss to the State include $50.4 million for the Food Stamp Program.

Lakeland Neurocare et al v State of Michigan: Two lawsuits involving a group of eight non-Medicaid nursing homes challenge the constitutionality and legality of MCL 333.20161. Originally enacted in May 2002, this provision requires Department of Community Health (DCH) to assess a "bed tax" against all non-governmental nursing homes, to use this revenue to draw down "matching" federal funds, and to pay the combined sum to Medicaid nursing homes as increased reimbursement. For the first fiscal year, this resulted in more than $100 million in increased payments. For the 2003-2004 fiscal year, this sum more than doubled. In November 2003, Ingham County Circuit Court Judge William Collette ruled that the original version of the Act violated the constitution by not distinctly stating the assessment as a tax. In December 2003, the Legislature corrected this misunderstanding, made it retroactive to May 2002, and increased the cap on the amount the DCH could assess. In two subsequent rulings, Judge Collette has effectively exempted the plaintiff homes from payment of the tax for two periods of time. The first of those – compelling repayment of $1.3 million escrowed from 2002-2003 – is pending before the Court of Appeals on application for leave. The second of them – enjoining collection of the tax for

the period October 1, 2003 through December 28, 2003 - will also be appealed when the order enters. DCH is concerned that, if allowed to stand, these exemptions will result in the federal government finding that Michigan's bed tax violates the governing law, 42 USC 1396b(w) – by not being uniformly imposed on the entire class. This translates to potential disallowances totaling more than $150 million for the two years.

Gain Contingencies
Certain contingent receivables related to the Family Independence Agency are not recorded as assets in these statements. Amounts recoverable from Family Independence Agency grant recipients for grant overpayments or from responsible third parties are recorded as receivables only if the amount is reasonably measurable, expected to be received within 12 months, and not contingent upon future grants or the completion of major collection efforts by the State. If recoveries are accrued and the program involves federal participation, a liability for the federal share of the recovery is also accrued. The unrecorded amount of potential recoveries, which are ultimately collectible, cannot be reasonably determined.

In November 1998, the Attorney General joined 45 other states and five territories in a settlement agreement against the nation's largest tobacco manufacturers, to seek restitution for monies spent by the states under Medicaid and other health care programs for treatment of smoking-related diseases and conditions. Michigan's share of the settlement is expected to be $8.5 billion over the next 25 years, and then $350.0 million per year, adjusted for inflation and other factors, in perpetuity. While Michigan's percentage share of the base payments will not change over time, the amount of the annual payment is subject to a number of modifications including adjustments for inflation and usage volumes. Some of the adjustments may result in increases in the payments (inflation, for example), while other adjustments will likely cause decreases in the payments (non-participating manufacturer adjustments, for example). The net effect of these adjustments on future payments is unclear, therefore only receivables and deferred revenues which can be reasonably estimated have been recorded for the future payments.

Construction Projects
The Department of Transportation has entered into construction contracts that will be paid with transportation related funds. As of September 30, 2004, the balances remaining in these contracts equaled $545.5 million.

Contingent Liability for Local School District Bonds
Public Act 108 of 1961, as amended, resulted in a contingent liability for the bonds of any school district which are "qualified" by the Superintendent of Public Instruction. Every qualified school district is required to borrow and the State is required to lend to it any amount necessary for the school district to avoid a default on its qualified bonds. In the event that funds are not available in the School Bond Loan Fund in adequate amounts to make such a loan, the State is required to make such loans from the General Fund. As of September 30, 2004, the principal amount of qualified bonds outstanding was $13.5 billion. Total debt service requirements on these bonds including interest will approximate $1.2 billion in 2005. The amount of loans by the State (related to local school district bonds qualified under this program), outstanding to local school districts as of September 30, 2004, is $527.4 million. Interest due on these loans as of September 30, 2004, is $87.7 million.

B. Discretely Presented Component Units

Student Loan Guarantees
The Michigan Higher Education Assistance Authority (MHEAA) is contingently liable for loans made to students by financial institutions that qualify for guaranty. The State, other than MHEAA, is not liable for these loans. MHEAA's default ratio is currently below 5% for the fiscal year ended September 30, 2004. As a result, the federal government's reinsurance rate for defaults for the fiscal year ended September 30, 2004, is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1, 1993, to September 30, 1998. In the event of future adverse default experience, MHEAA could be liable for up to 25% of defaulted loans. Management does not expect that all guaranteed loans could default in one year. At the beginning of each fiscal year, MHEAA's reinsurance rate returns to 98%.

For loans made on or after October 1, 1998, the reinsurance rate will be 95%. In the event of future adverse default experience, MHEAA could be liable for up to 25% of such defaulted loans. Accordingly, MHEAA's expected maximum contingent liability is less than 25% of outstanding guaranteed loans; however, the maximum contingent liability at September 30, 2004, is $759.4 million.

MHEAA entered into commitment agreements with all lenders that provide, among other things, that MHEAA will maintain cash and marketable securities. MHEAA was in compliance with this requirement as of September 30, 2004, at an amount sufficient to guarantee loans in accordance with the Higher Education Act of 1965, as amended.

Multi-Family Mortgage Loans
As of June 30, 2004, the Michigan State Housing Development Authority (MSHDA) has commitments to issue multi-family mortgage loans in the amount of $77.4 million and single-family mortgage loans in the amount of $7.7 million.

MSHDA has committed up to approximately $2.1 million per year for up to 30 years from the date of completion of the respective developments (subject to three years advance notice of termination) from its accumulated reserves and future income to subsidize operations or rents for certain tenants occupying units in certain developments funded under MSHDA's multi-family program.